VIII. BLUE RIBBON COMMISSION ON COMPREHENSIVE TAX REFORM (secs. 601-607 of the Senate amendment)

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The Senate amendment establishes the Blue Ribbon Commission on Comprehensive Tax Reform (the "Commission"). The Commission is composed of 12 members, of whom: (1) one is the Chairman of the Board of the Federal Reserve System; (2) two are appointed by the majority leader of the Senate; (3) two are appointed by the minority leader of the Senate; (4) two are appointed by the Speaker of the House of Representatives; (5) two are appointed by the minority leader of the House of Representatives; and (6) three are appointed by the President, of which no more than two will be of the same party as the President. Members of the Commission may be employees or former employees of the Federal Government. Appointments of Commission members will be made not later than July 30, 2003. Members of the Commission will be appointed for the life of the Commission. Any vacancy in the Commission will not affect its powers but will be filled in the same manner as the original appointment.

The Commission will hold its first meeting not later than 30 days after the date on which all Commission members have been appointed. The President will select a Commission Chairman ("Chairman") and Vice Chairman from among the members of the Commission. The Commission will meet at the call of the Chairman. A majority of the members of the Commission will constitute a quorum, but a lesser number of members may hold hearings (discussed below).

The Commission will conduct a thorough study of all matters relating to a comprehensive reform of the Federal tax system, including the reform of the Internal Revenue Code of 1986 and the implementation (if appropriate) of other types of tax systems. The Commission will develop recommendations on how to comprehensively reform the Federal tax system in a manner that generates appropriate revenue for the Federal Government. Not later than 18 months after the date on which all initial members of the Commission have been appointed, the Commission will submit a report to the President and Congress which will contain a detailed statement of the findings and conclusions of the Commission, together with its recommendations for such legislation and administrative actions as it considers appropriate.

The Commission may hold such hearings, sit and act at such times and places, take such testimony, and receive such evidence as the Commission considers advisable to carry out the amendment. Additionally, the Commission may secure directly from any Federal department or agency such information as the Commission considers necessary to carry out the amendment. Upon request of the Chairman, the head of such department or agency will furnish such information to the Commission. The Commission may use the United States mails in the same manner and under the same condition as other departments and agencies of the Federal Government. The Commission may accept, use, and dispose of gifts or donations of services or property.

Each member of the Commission who is not an officer or employee of the Federal Government will be compensated at a rate equal to the daily equivalent of a prescribed annual rate of pay[384] for each day (including travel time) during which such member is engaged in the performance of the duties of the Commission. All members of the Commission who are officers or employees of the United States will serve without compensation in addition to that received for their services as officers or employees of the United States. Commission members will be allowed travel expenses, including per diem in lieu of subsistence, at rates authorized for employees of agencies while away from their homes or regular places of business in the performance of services for the Commission.[385]

The Chairman, without regard to the civil service laws and regulations, may appoint and terminate an executive director and such other additional personnel as may be necessary to enable the Commission to perform its duties. The employment of an executive director will be subject to confirmation by the Commission. The Chairman may fix the compensation of the executive director and other personnel without regard to classification of positions and general schedule pay rates,[386] except that the rate of pay for the executive director and other personnel may not exceed the rate payable for level V of the executive schedule.[387]

Any employee of the Federal Government may be detailed to the Commission without reimbursement, and such detail will be without interruption or loss of civil service status or privilege. The Chairman may procure temporary and intermittent services[388] at rates for individuals which do not exceed the daily equivalent of the annual rate of basic pay prescribed for level V of the executive schedule.

The Commission will terminate 90 days after the date on which the Commission submits the report required by the provision. Such sums as are necessary to carry out the Senate amendment are appropriated.

Effective date.–The Senate amendment is effective on the date of enactment.

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[384] The applicable rate of pay is the basic pay prescribed for level IV of the Executive Schedule under 5 U.S.C. 5315.

[385] Subchapter I of chapter 57 of title 5, U.S.C.

[386] Chapter 51 and subchapter III of chapter 53 of title 5, U.S.C.

[387] 5 U.S.C. 5316.

[388] 5 U.S.C. 3109(b).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

IX. REIT PROVISIONS

A. REIT Modification Provisions
(secs. 701-707 of the Senate amendment and secs. 856 and 857 of the Code)

Present Law

In general

Real estate investment trusts ("REITs") are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for dividends paid to its shareholders. REITs are generally restricted to investing in passive investments primarily in real estate and securities.

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. Whether the REIT meets the asset tests is generally measured each quarter.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees. The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares.

Income requirements

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent income test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent income test"), including rents from real property (as defined) and gain from the sale or other disposition of real property.

Qualified rental income

Amounts received as impermissible "tenant services income" are not treated as rents from real property.[389] In general, such amounts are for services rendered to tenants that are not

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[389] A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no

"customarily furnished" in connection with the rental of real property.[390] Special rules also permit amounts to be received from certain "foreclosure property" treated as such for 3 years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or an indebtedness which such property secured.

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT owns, directly or indirectly, 10 percent or more of the vote or value.[391] An exception applies to rents received from a taxable REIT subsidiary ("TRS") (described further below) if at least 90 percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.[392]

Certain hedging instruments

Except as provided in regulations, a payment to a REIT under an interest rate swap or cap agreement, option, futures contract, forward rate agreement, or any similar financial instrument, entered into by the trust in a transaction to reduce the interest rate risks with respect to any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets, and any gain from the sale or disposition of any such investment, is treated as income qualifying for the 95-percent income test.

Tax if qualified income tests not met

If a REIT fails to meet the 95-percent or 75-ercent income tests but has set out the income it did receive in a schedule and any error in the schedule is due to reasonable cause and not willful neglect, then the REIT does not lose its REIT status but instead pays a tax measured by the greater of the amount by which 90 percent [393] of the REIT's gross income exceeds the amount of items subject to the 95-percent test, or the amount by which 75 percent of the REIT's gross income exceeds the amount of items subject to the 75-percent test.[394]

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more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

[390] Rents for certain personal property leased in connection are treated as rents from real property if the fair market value of the personal property does not exceed 15 percent of the aggregate fair market values of the real and personal property

[391] Section 856(d)(2)(B).

[392] Section 856(d)(8).

[393] Prior to 1999, the rule had applied to the amount by which 95 percent of the income exceeded the items subject to the 95 percent test.

[394] The ratio of the REIT's net to gross income is applied to the excess amount, to determine the amount of tax (disregarding certain items otherwise subject to a 100-percent tax).

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. A 100 percent tax is imposed on the net income of a REIT from "prohibited transactions". A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property.[395] A safe harbor is provided for certain sales of rent producing real property that otherwise might be considered prohibited transactions. The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year. The safe harbor only applies to property that has been held by the REIT for at least 4 years. In addition, property is eligible for the safe harbor only if the aggregate expenditures made directly or indirectly by the REIT during the 4-year period prior to date of sale do not exceed 30 percent of the net selling price of the property.

Certain timber income

REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT to its taxable REIT subsidiary, which cuts and logs the trees and processes the timber to produce lumber, lumber products such a plywood or composite. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.[396]

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (the "75-percent asset test"). The term real estate asset is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs.

In effect, the formula seeks to require that all of the REIT net income attributable to the failure of the income tests will be paid as tax. Sec. 857(b)(5).

[395] Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project.

[396] See, e.g., PLR 200052021, PLR 199945055, PLR 19927021, PLR 8838016. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued. However, such rulings provide an indication of administrative practice.

Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.

"Straight debt" exception

Securities of an issuer that are within a safe-harbor definition of "straight debt" (as defined for purposes of subchapter S[397] are not taken into account in applying the limitation that a REIT may not hold more than 10 percent of the value of outstanding securities of a single issuer, if : 1) the issuer is an individual, or 2) the only securities of such issuer held by the REIT or a taxable REIT subsidiary of the REIT are straight debt, or 3) the issuer is a partnership and the trust holds at least a 20 percent profits interest in the partnership.

Straight debt is defined as a written or unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; (ii) there is no convertibility (directly or indirectly) into stock; and (iii) the creditor is an individual (other than a nonresident alien), an estate, certain trusts, or a person which is actively and regularly engaged in the business of lending money.

Certain subsidiary ownership permitted with income treated as income of the REIT

Under one exception to the rule limiting a REIT's securities holdings to no more than 10 percent of the vote or value of a single issuer, a REIT can own 100 percent of the stock of a corporation, but in that case the income and assets of such corporation are treated as income and assets of the REIT.

Special rules for Taxable REIT subsidiaries

Under another exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than a real estate investment trust[398] with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income

[397] Section 1361(c)(5), without regard to paragraph (B)(iii) thereof.

[398] Certain corporations are not eligible to be a TRS, such as a corporation which directly or indirectly operates or manages a lodging facility or a health care facility or directly or indirectly provides to any other person rights to a brand name under which any lodging facility or health care facility is operated. Sec. 856((l)(3).

tests for a REIT, and that income is not attributed to the REIT. For example a TRS could provide noncustomary services to REIT tenants, or it could engage directly in the active operation and management of real estate (without use of an independent contractor); and the income the TRS derived from these nonqualified activities would not be treated as disqualified REIT income. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100 percent excise tax is imposed on rents, deductions, or interest paid by the TRS to the REIT to the extent such items would exceed an arm's length amount as determined under section 482.[399]

Rents subject to the 100 percent excise tax do not include rents for services of a TRS that are for services customarily furnished or rendered in connection with the rental of real property.

They also do not include rents from a TRS that are for real property or from incidental personal property provided with such real property.

Income distribution requirements

A REIT is generally required to distribute 90 percent of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies ("RICs") that requires distribution of 90 percent of income. Both RICS and REITs can make certain "deficiency dividends" after the close of the taxable year, and have these treated as made before the end of the year. Deficiency dividends may be declared on or after the date of "determination". A determination is defined to include only (i) a final decision by the Tax Court or other court of competent jurisdiction, (ii) a closing agreement under section 7121, or (iii) under Treasury regulations, an agreement signed by the Secretary and the REIT.

House Bill

No provision.

Senate Amendment

The Senate amendment makes a number of modifications to the REIT rules.

Straight debt modification

The provision modifies the definition of "straight debt" for purposes of the limitation that a REIT may not hold more than 10 percent of the value of the outstanding securities of a single issuer, to provide more flexibility than the present law rule. In addition, except as provided in regulations, neither such straight debt nor certain other types of securities are considered "securities" for purposes of this rule.

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[399] If the excise tax applies, the item is not also reallocated back to the TRS under section 482.

Straight debt securities

"Straight-debt" is still defined by reference to section 1361(c)(5), however, without regard to subparagraph (B)(iii) thereof (limiting the nature of the creditor).

Special rules are provided permitting certain contingencies for purposes of the REIT provision. Any interest or principal shall not be treated as failing to satisfy section 1361(c)(5)(B)(i) solely by reason of the fact that the time of payment of such interest or principal is subject to a contingency, but only if one of several factors applies. The first type of contingency that is permitted is one that does not have the effect of changing the effective yield to maturity, as determined under section 1272, other than a change in the annual yield to maturity which either (i) does not exceed the greater of ¼ of 1 percent or 5 percent of the annual yield to maturity, or (ii) results solely from a default or the exercise of a prepayment right by the issuer of the debt.

The second type of contingency that is permitted is one under which neither the aggregate issue price nor the aggregate face amount of the debt instruments held by the REIT exceeds $1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.

The bill eliminates the present law rule requiring a REIT to own a 20 percent equity interest in a partnership in order for debt to qualify as "straight debt". The bill instead provides new "look-through" rules determining a REIT partner's share of partnership securities, generally treating debt to the REIT as part of the REIT's partnership interest for this purpose, except in the case of otherwise qualifying debt of the partnership.

Certain corporate or partnership issues that otherwise would be permitted to be held without limitation under the special straight debt rules described above will not be so permitted if the REIT holding such securities, and any of its taxable REIT subsidiaries, holds any securities of the issuer which are not permitted securities (prior to the application of this rule) and have an aggregate value greater than 1 percent of the issuer's outstanding securities.

Other securities

Except as provided in regulations, the following also are not considered "securities" for purposes of the rule that a REIT cannot own more than 10 percent of the value of the outstanding securities of a single issuer: (i) any loan to an individual or an estate, (ii) any section 467 rental agreement, (as defined in section 467(d)), other than with a person described in section 856(d)(2)(B), (iii) any obligation to pay rents from real property, (iv) any security issued by a State or any political subdivision thereof, the District of Columbia, a foreign government, or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under such security does not depend in whole or in part on the profits of any entity not described in this category, or payments on any obligation issued by such an entity, (v) any security issued by a real estate investment trust; (vi) any other arrangement that, as determined by the Secretary, is excepted from the definition of a security.

Safe harbor testing date for certain rents

The bill provides specific safe-harbor rules regarding the dates for testing whether 90 percent of a REIT property is rented to unrelated persons and whether the rents paid by related persons are substantially comparable to unrelated party rents. These testing rules are provided solely for purposes of the special provision permitting rents received from a related party to be treated as qualified rental income for purposes of the income tests.[400]

Customary services exception

The bill prospectively eliminates the safe harbor allowing rents received by a REIT to be exempt from the 100 percent excise tax if the rents are for customary services performed by the TRS[401] or are from a TRS and are for the provision of certain incidental personal property. Instead, such payments would be free of the excise tax if they satisfy the present law safe-harbor that applies if the REIT pays the TRS at least 150 percent of the cost to the TRS of providing any services.

Hedging rules

The rules governing the tax treatment of arrangements engaged in by a REIT to reduce interest rate risks are prospectively conformed to the rules included in section 1221.

95-percent gross income requirement

The bill prospectively amends the tax liability owed by the REIT when it fails to meet the 95-percent of gross income test by applying a taxable fraction based on 95 percent, rather than 90 percent of the REIT's gross income.

Safe harbor from prohibited transactions for certain timberland sales

The bill provides that a sale of a real estate asset will not be a prohibited transaction the following six requirements are met:

(1) The asset must have been held for at least 4 years in the trade or business of producing timber;

(2) The aggregate expenditures made the REIT (or a partner of the REIT) during the 4-year period preceding the date of sale that are includible in the basis of the property that are directly related to the operation of the property for the

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[400] The proposal does not modify any of the standards of section 482 as they apply to REITS and to taxable REIT subsidiaries.

[401] Although a REIT could itself provide such services and receive the income for them without receiving any disqualified income, in that case the REIT itself would be bearing the cost of providing the service. Under the present law exception for a TRS providing such service, there is no explicit requirement that the TRS be reimbursed for the full cost of the service.

production of timber or for the preservation of the property for use as timberland must not exceed 30 percent of the net selling price of the property;

(3) The aggregate expenditures made the REIT (or a partner of the REIT) during the 4-year period preceding the date of sale that are includible in the basis of the property that do not qualify under the second requirement (i.e., those expenditures are not directly related to the operation of the property for the production of timber or the preservation of the property for use as timberland) must not exceed 5 percent of the net selling price of the property;

(4) The REIT either (i) does not make more than 7 sales of property (other than sales of foreclosure property or sales to which 1033 applies) or (ii) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property sold during the year (other than sales of foreclosure property or sales to which 1033 applies) does not exceed 10 percent of the aggregate bases (as determined for purposes of computing earnings and profits)of property of all assets of the REIT as of the beginning of the year;

(5) Substantially all of the marketing expenditure with respect to the property are made by persons who an independent contractor (as defined by section 856(d)(3) with respect to the REIT and from whom the REIT does not derive any income; and

(6) The sales price of the sale of the property to a taxable REIT subsidiary cannot be based in whole or in part on the income or profits that the subsidiary derives from the sales of such properties.

Costs that are not includible in the basis of the property are not counted towards either the 30 or 5 percent requirements.

<u>Capital expenditures counted towards 30-percent requirement</u>

Capital expenditures counted towards the 30-percent limit are those expenditures that are includible in the basis of the property (other than timberland acquisition expenditures), and that are directly related to operation of the property for the production of timber, or for the preservation of the property for use as timberland. These capital expenditures are those incurred directly in the operation of raising timber (*i.e.*, silviculture), as opposed to capital expenditures incurred in the ownership of undeveloped land. In general, these capital expenditures incurred directly in the operation of raising timber include capital expenditures incurred by the REIT to create an established stand of growing trees. A stand of trees is considered established when a target stand exhibits the expected growing rate and is free of non-target competition (e.g., hardwoods; grasses, brush, etc.) that may significantly inhibit or threaten the target stand survival. The costs commonly incurred during stand establishment are: (1) site preparation including manual or mechanical scarification, manual or mechanical cutting, disking, bedding, shearing, raking, piling, broadcast and windrow/pile burning (including slash disposal costs as required for stand establishment); 2) site regeneration including manual or mechanical hardwood coppice; (3) chemical application via aerial or ground to eliminate or reduce vegetation; (4)

nursery operating costs including personnel salaries and benefits, facilities costs, cone collection and seed extraction, and other costs directly attributable to the nursery operations (to the extent such costs are allocable to seedlings used by the REIT); (5) seedlings including storage, transportation and handling equipment; (6) direct planting of seedlings; (7) initial stand fertilization, up through stand establishment; (8) construction cost of road to be used for removal of logs or fire protection; (9) environmental costs (*i.e.*, habitat conservation plans), (10) any post stand capital establishment costs (*e.g.*, "mid-term fertilization costs)."

Capital expenditures counted towards 5-percent requirement

Capital expenditures counted towards the 5-percent limit are those capital expenditures incurred in the ownership of undeveloped land that are not incurred in the direct operation of raising timber (*i.e.*, silviculture). This category of capital expenditures includes (1) expenditures to separate the REIT's holdings of land into separate parcels; (2) costs of granting leases or easements to cable, cellular or similar companies, (3) costs in determining the presence or quality of minerals located on the land; (4) costs incurred to defend changes in law that would limit future use of the land by the REIT or a purchaser from the REIT; and (5) costs incurred to determine alternative uses of the land (*e.g.*, recreational use); and (6) development costs of the property incurred by the REIT (*e.g.*, engineering, surveying, legal, permit, consulting, road construction, utilities, and other development costs for use other than to grow timber).

Effective date

The bill is generally effective for taxable years beginning after December 31, 2000.

However, some of the provisions are effective for taxable years beginning after the date of enactment. These are: the new "look through" rules determining a REIT partner's share of partnership securities for purposes of the "straight debt" rules; the provision changing the 90-percent of gross income reference to 95 percent, for purposes of the tax liability if a REIT fails to meet the 95-ercent of gross income test; the new hedging definition; the rule modifying the treatment of rents with respect to customary services; and the safe harbor from prohibited transactions relating to timberland sales.[402]

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[402] The provision relating to timberland sales is not intended to change present law regarding when structures involving timberland may qualify for REIT status.

B. REIT Savings Provisions
(sec. 711 of the Senate amendment and secs. 856, 857 and 860 of the Code)

Present Law

A REIT loses its status as a REIT, and becomes subject to tax as a C corporation, if it fails to meet specified tests regarding the sources of its income, the nature and amount of its assets, its structure, and the amount of its income distributed to shareholders.[403]

In the case of a failure to meet the source of income requirements, if the failure is due to reasonable cause and not to willful neglect, the REIT may continue its REIT status if it pays the disallowed income as a tax to the Treasury.[404]

There is no similar provision that allows a REIT to pay a penalty and avoid disqualification in the case of other qualification failures.

A REIT may make a deficiency dividend after a determination is made that it has not distributed the correct amount of its income, and avoid disqualification. The Code provides only for determinations involving a controversy with the IRS and does not provide for a REIT to make such a distribution on its own initiative.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, a REIT may avoid disqualification in the event of certain failures of the requirements for REIT status, provided that 1) the failure was due to reasonable cause and not willful neglect, 2) the failure is corrected, and 3) a penalty amount is paid.

One requirement of present law is that, with certain exceptions, (i) not more than 5 percent of the value of total REIT assets may be represented by securities of one issuer, and (ii) a REIT may not hold securities possessing more than 10 percent of the total voting power or 10 percent of the total value of the outstanding securities of any one issuer.[405] The requirements must be satisfied each quarter.

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[403] See description of *Present Law* under REIT modification provisions, *supra.*

[404] Sec. 856(c)(6) and Sec. 857(b)(5).

[405] Sec. 856(c)(4)(B)(iii). These rules do not apply to securities of a taxable REIT subsidiary, or to securities that qualify for the 75 percent asset test of section 856(c)(4)(A), such as real estate assets, cash items (including receivables), or Government securities.

Certain de minimis asset failures of 5-percent or 10-percent tests

The bill provides that a REIT will not lose its REIT status for failing to satisfy these requirements in a quarter if the failure is due to the ownership of assets the total value of which does not exceed the lesser of (i) 1 percent of the total value of the REIT's assets at the end of the quarter for which such measurement is done or (ii) 10 million dollars; provided in either case that the REIT either disposes of the assets within 6 months after the last day of the quarter in which the REIT identifies the failure (or such other time period prescribed by the Treasury), or otherwise meets the requirements of those rules by the end of such time period.[406]

Larger asset test failures (whether of 5-percent or 10-percent tests, or of 75-percent or other asset tests)

If a REIT fails to meet any of the asset test requirements requirements for a particular quarter and the failure exceeds the de minimis threshold described above, then the REIT still will be deemed to have satisfied the requirements if: (i) following the REIT's identification of the failure, the REIT files a schedule with a description of each asset that caused the failure, in accordance with regulations prescribed by the Treasury; (ii) the failure was due to reasonable cause and not to willful neglect, (iii) the REIT disposes of the assets within 6 months after the last day of the quarter in which the identification occurred or such other time period as is prescribed by the Treasury (or the requirements of the rules are otherwise met within such period), and (iv) the REIT pays a tax on the failure.

The tax that the REIT must pay on the failure is the greater of (i) $50,000, or (ii) an amount determined (pursuant to regulations) by multiplying the highest rate of tax for corporations under section 11, times the net income generated by the assets for the period beginning on the first date of the failure and ending on the date the REIT has disposed of the assets (or otherwise satisfies the requirements).

Such taxes are treated as excise taxes, for which the deficiency provisions of the excise tax subtitle of the Code (subtitle F) apply.

Conforming reasonable cause and reporting standard for failures of income tests

The bill conforms the reporting and reasonable cause standards for failure to meet the income tests to the new asset test standards. However, the bill does not change the rule under section 857(b)(5) that for income test failures, all of the net income attributed to the disqualified gross income is paid as tax.

Other failures

The bill adds a provision under which, if a REIT fails to satisfy one or more requirements for REIT qualification, other than the 95-percent and 75-percent gross income tests and other

[406] A REIT might satisfy the requirements without a disposition, for example, by increasing its other assets in the case of the 5 percent rule; or by the issuer modifying the amount or value of its total securities outstanding in the case of the 10 percent rule.

than the new rules provided for failures of the asset tests, the REIT may retain its REIT qualification if the failures are due to reasonable cause and not willful neglect, and if the REIT pays a penalty of $50,000 for each such failure.

Taxes and penalties paid deducted from amount required to be distributed

Any taxes or penalties paid under the provision are deducted from the net income of the REIT in determining the amount the REIT must distribute under the 90 percent distribution requirement.

Expansion of deficiency dividend procedure

The Senate amendment expands the circumstances in which a REIT may declare a deficiency dividend, by allowing such a declaration to occur after the REIT unilaterally has identified a failure to pay the relevant amount. Thus, the declaration need not await a decision of the Tax Court, a closing agreement, or an agreement signed by the Secretary of the Treasury.

Effective date.–The Senate amendment provision is effective for taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

X. EXTENSION OF CERTAIN EXPIRING PROVISIONS

A. Tax on Failure to Comply with Mental Health Parity Requirements (sec. 801 of the Senate amendment and sec. 9812 of the Code)

Present Law

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, and expire with respect to benefits for services furnished on or after December 31, 2003.[407]

The Taxpayer Relief Act of 1997 added to the Internal Revenue Code the requirements imposed under the Mental Health Parity Act, and imposed an excise tax on group health plans that fail to meet the requirements. The excise tax is equal to $100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

The excise tax is applicable with respect to plan years beginning on or after January 1, 1998, and expires with respect to benefits for services provided on or after December 31, 2003.[408]

House Bill

No provision.

Senate Amendment

The Senate amendment extends the excise tax for failures to comply with mental health parity requirements through December 31, 2004.

Effective date.–The Senate amendment is effective for plan years beginning after December 31, 2002.

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[407] Since enactment, the mental health parity requirements have been extended on more than one occasion.

[408] The excise tax does not apply to benefits for services furnished on or after September 30, 2001, and before January 10, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

B. Extend Alternative Minimum Tax Relief for Individuals (sec. 802 of the Senate amendment and sec. 26 of the Code)

Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit,[409] the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the IRA credit, and the D.C. homebuyer's credit).

For taxable years beginning in 2003, all the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

Without an extension of these rules for taxable years beginning after 2003, these credits (other than the adoption credit, child credit and IRA credit) would be allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 ($49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($35,750 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) $22,500 ($24,500 in taxable years beginning before 2005) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

House Bill

No provision.

[409] A portion of the child credit may be refundable.

Senate Amendment

The Senate amendment provision extends the provisions allowing an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits for one year.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

C. Extension of Electricity Production Credit for Electricity Produced from Certain Renewable Resources (sec. 803 of the Senate amendment and sec. 45 of the Code)

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced.[410] The credit is allowable for production during the 10-year period after a facility is originally placed in service.

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2004, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2004, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2004.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the placed in service date for qualified facilities from facilities placed in service before January 1, 2004 to facilities placed in service before January 1, 2005.

Effective date.–The Senate amendment provision is effective for property placed in service after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[410] The amount of the credit is 1.8 cents per kilowatt hour for 2002.

D. Extend the Work Opportunity Tax Credit (sec. 804 of the Senate amendment and sec. 51 of the Code)

Present Law

In general

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of less than 400 hours) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

Targeted groups eligible for the credit

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families ("TANF") Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income ("SSI") benefits.

The employer's deduction for wages is reduced by the amount of the credit.

Expiration date

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2004.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the work opportunity tax credit for one year (through December 31, 2004).

Effective date.–The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2004, and before January 1, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

E. Extend the Welfare-To-Work Tax Credit (sec. 805 of the Senate amendment and sec. 51A of the Code)

Present Law

In general

The welfare-to-work tax credit is available on an elective basis for employers for the first $20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family that is no longer eligible for family assistance because of either Federal or State time limits, if they are hired within two years after the Federal or State time limits made the family ineligible for family assistance. Family assistance means benefits under the Temporary Assistance to Needy Families ("TANF") program.

For purposes of the credit, wages are generally defined under the Federal Unemployment Tax Act, without regard to the dollar amount. In addition, wages include the following: (1) educational assistance excludable under a section 127 program; (2) the value of excludable health plan coverage but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The employer's deduction for wages is reduced by the amount of the credit.

Expiration date

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2004.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the welfare-to-work tax credit for one year (through December 31, 2004).

Effective date.–The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2004, and before January 1, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

F. Taxable Income Limit on Percentage Depletion for Oil and Natural Gas Produced from Marginal Properties (sec. 806 of the Senate amendment and sec. 613A of the Code)

Present Law

In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset -- in the case of depletion for oil or gas interests, the mineral reserve itself -- is being expended in order to produce income. Certain costs incurred prior to drilling an oil or gas property are recovered through the depletion deduction. These include costs of acquiring the lease or other interest in the property and geological and geophysical costs (in advance of actual drilling). Depletion is available to any person having an economic interest in a producing property.

Two methods of depletion are allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method (secs. 611-613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, generally, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (section 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (section 613(a)). The 100-percent-of-net-income limitation for production from marginal wells has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2004. Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (section 613A(d)(1)).[411] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (section 613(a)).

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[411] Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

Limitation of oil and gas percentage depletion to independent producers and royalty owners

Generally, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion. Percentage depletion for eligible taxpayers is allowed only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (section 613A(c)). For producers of both oil and natural gas, this limitation applies on a combined basis.

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine, are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

House Bill

No provision.

Senate Amendment

The Senate amendment extends for an additional year the suspension of the 100-percent net-income limit for marginal wells to include taxable years beginning after December 31, 2003 and before January 1, 2005.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

G. Qualified Zone Academy Bonds
(sec. 807 of the Senate amendment and sec. 1397E of the Code)

Present Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (sec. 103).

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds" ("QZABs") (sec. 1397E). A total of $400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2003. The $400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that: (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy", and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if: (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

House Bill

No provision.

Senate Amendment

The Senate amendment authorizes issuance of up to $400 million of qualified zone academy bonds for calendar year 2004.

Effective date.–The provision is effective for obligations issued after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

H. Cover Over of Tax on Distilled Spirits
(sec. 808 of the Senate amendment and sec. 7652(e) of the Code)

Present Law

A $13.50 per proof gallon[412] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of $13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999 through December 31, 2003. Effective on January 1, 2004, the coverover rate is scheduled to return to its permanent level of $10.50 per proof gallon.

Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the $13.25-per-proof-gallon coverover rate for one additional year, through December 31, 2004.

Effective date.–The Senate amendment provision is effective for articles brought into the United States after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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[412] A proof of gallon is a liquid gallon consisting of 50 percent alcohol.

I. Extend Deduction for Corporate Donations of Computer Technology (sec. 809 of the Senate amendment and sec. 170 of the Code)

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[413]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[414] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis.

A qualified computer contribution means a charitable contribution by a corporation of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is substantially completed.[415] The original use of the property must be by the donor or the donee,[416] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. That is, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a

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[413] Sec. 170(e)(1).

[414] Secs. 170(e)(4) and 170(e)(6).

[415] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[416] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

related person) does not exceed 50 percent of the taxpayer's basis in the property. Contributions may be made to private foundations under certain conditions.[417]

The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2003.

House Bill

No provision.

Senate Amendment

The Senate amendment provision extends the enhanced deduction for qualified computer contributions to apply to contributions made during taxable years beginning on or before December 31, 2004.

Effective date.–The Senate amendment provision is effective for contributions made after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[417] Sec. 170(e)(6)(C).

J. Extension of Credit for Electric Vehicles (sec. 810 of the Senate amendment and sec. 30 of the Code)

Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2004. The credit phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

House Bill

No provision.

Senate Amendment

The Senate amendment delays the beginning of the phase out of the credit by one year and provides that the credit is available for purchases through December 31, 2007.

Effective date.–The Senate amendment provision is effective for property placed in service after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

K. Extension of Deduction for Clean-Fuel Vehicles and Clean-Fuel Vehicle Refueling Property (sec. 811 of the Senate amendment and sec. 179A of the Code)

Present Law

Clean-fuel vehicles

Certain costs of qualified clean-fuel vehicle may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether). The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

Clean-fuel vehicle refueling property

Clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location. The deduction is unavailable for costs incurred after December 31, 2006.

House Bill

No provision.

Senate Amendment

The Senate amendment delays the beginning of the phase down of the deduction for qualified clean-fuel vehicle property by one year and provides that the deduction is available through December 31, 2007. The Senate amendment extends the deduction for clean-fuel vehicle refueling property by one year to include equipment placed in service prior to January 1, 2008.

Effective date.–The Senate amendment provision is effective for property placed in service after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

L. Adjusted Gross Income Determined by Taking into Account Certain Expenses of Elementary and Secondary School Teachers (sec. 812 of the Senate amendment and sec. 62 of the Code)

Present Law

In general, ordinary and necessary business expenses are deductible (sec. 162), and unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income.

However, an above-the-line deduction is allowed for taxable years beginning in 2002 and 2003 for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount of such expenses excludable from income under section 135 (relating to education savings bonds), section 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under State law.

An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $139,500 (for 2003).[418] In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the present-law above-the-line deduction for eligible educators to include taxable years beginning in 2004.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002.

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[418] The effect of this overall limitation is phased down beginning in 2006.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

M. Extend Archer Medical Savings Accounts ("MSAs") (sec. 813 of the Senate amendment and sec. 220 of the Code)

Present Law

In general

Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not includible in gross income. Distributions not used for medical expenses are includible in gross income. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan.[419] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if he or she is covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual's employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least $1,700 and no more than $2,500 in the case of individual coverage and at least $3,350 and no more than

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[419] Self-employed individuals include more than two-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

$5,050 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,350 in the case of individual coverage and no more than $6,150 in the case of family coverage.[420] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Cap on taxpayers utilizing Archer MSAs and expiration of pilot program

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of Archer MSAs established has not exceeded the threshold level.

After 2003, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer.

House Bill

No provision.

Senate Amendment

The Senate amendment extends Archer MSAs through December 31, 2004.

Effective date.–The Senate amendment provision is effective on January 1, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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[420] These dollar amounts are for 2003. These amounts are indexed for inflation in $50 increments.

N. Extension of Expensing of Brownfield Remediation Expenses (sec. 814 of the Senate amendment and sec. 198 of the Code)

Present Law

Under Code section 198, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*[421] and section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" (a so-called "brownfield") generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

Eligible expenditures are those paid or incurred before January 1, 2004.

House Bill

No provision.

Senate Amendment

The Senate amendment extends by one year the present-law deduction for environmental remediation expenditures to include expenditures incurred prior to January 1, 2005.

Effective date.–The Senate amendment provision is effective for expenditures incurred after December 31, 2002.

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[421] *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

XI. IMPROVING TAX EQUITY FOR MILITARY PERSONNEL

A. Exclusion of Gain on Sale of a Principal Residence by a Member of the Uniformed Services or the Foreign Service (sec. 901 of the Senate amendment and sec. 121 of the Code)

Present Law

Under present law, an individual taxpayer may exclude up to $250,000 ($500,000, if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to members of the uniformed services or the Foreign Service of the United States.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, an individual may elect to suspend for a maximum of ten years the five-year test period for ownership and use during certain absences due to service in the uniformed services, or the Foreign Service of the United States. The uniformed services include: (1) the Armed forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to ten years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services, or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty by a member of the uniformed services, or the Foreign Service of the United States while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in Government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Effective date.–The Senate amendment provision is effective for sales or exchanges after May 6, 1997.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

B. Exclusion from Gross Income of Certain Death Gratuity Payments (sec. 902 of the Senate amendment and sec. 134 of the Code)

Present Law

Present law provides that qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) which: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income. Qualified military benefits include certain death gratuities. The amount of the death gratuity military benefit was increased to $6,000 but the amount of the exclusion from gross income was not increased to take into account this change.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the exclusion from gross income to any adjustment to the amount of the death gratuity payable under Chapter 75 of Title 10 of the United States Code that is pursuant to a provision of law with respect to the death of certain members of the Armed services on active duty, inactive duty training, or engaged in authorized travel. Therefore, the amount of the exclusion is increased to $6,000.

Effective date.–The Senate amendment provision is effective with respect to deaths occurring after September 10, 2001.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

C. Exclusion for Amounts Received Under Department of Defense Homeowners Assistance Program (sec. 903 of the Senate amendment and sec. 132 of the Code)

Present Law

HAP payment

The Department of Defense Homeowners Assistance Program ("HAP") provides payments to certain employees and members of the Armed Forces to offset the adverse effects on housing values that result from a military base realignment or closure. The payments are authorized under the provisions of Title 42 U.S.C. section 3374.

In general, under HAP, eligible individuals receive either (1) a cash payment as compensation for losses that may be or have been sustained in a private sale, in an amount not to exceed the difference between (a) 95 percent of the fair market value of their property prior to public announcement of intention to close all or part of the military base or installation and (b) the fair market value of such property at the time of the sale, or (2) as the purchase price for their property, an amount not to exceed 90 percent of the prior fair market value as determined by the Secretary of Defense, or the amount of the outstanding mortgages.

Tax treatment

Unless specifically excluded, gross income for Federal income tax purposes includes all income from whatever source derived. Amounts received under HAP are received in connection with the performance of services. These amounts are includible in gross income as compensation for services to the extent such payments exceed the fair market value of the property relinquished in exchange for such payments. Additionally, such payments are wages for Federal Insurance Contributions Act ("FICA") tax purposes (including Medicare).

House Bill

No provision.

Senate Amendment

The Senate amendment generally exempts from gross income amounts received under the HAP (as in effect on the date of enactment of this Senate amendment). Amounts received under the program also are not considered wages for FICA tax purposes (including Medicare). The excludable amount is limited to the reduction in the fair market value of property.

Effective date.–The Senate amendment provision is effective for payments made after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

D. Expansion of Combat Zone Filing Rules to Contingency Operations (sec. 904 of the Senate amendment and sec. 7508 of the Code)

Present Law

General time limits for filing tax returns

Individuals generally must file their Federal income tax returns by April 15 of the year following the close of a taxable year. The Secretary may grant reasonable extensions of time for filing such returns. Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty on April 15 of the following year (the otherwise applicable due date of the return) outside the United States. No action is necessary to apply for this extension, but taxpayers must indicate on their returns (when filed) that they are claiming this extension. Unlike most extensions of time to file, this extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual timely filing that form and paying the amount of tax estimated to be due.

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

Suspension of time periods

In general, the period of time for performing various acts under the Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities. An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspension of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. The President must also designate the period of combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the combat zone[422] or (2) time in missing in action status, plus the next 180 days.

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[422] Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United States are applicable only to the hospitalized individual; they are not applicable to the spouse of such

The suspension of time applies to the following acts:

(1) Filing any return of income, estate, or gift tax (except employment and withholding taxes);

(2) Payment of any income, estate, or gift tax (except employment and withholding taxes);

(3) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;

(4) Allowance of a credit or refund of any tax;

(5) Filing a claim for credit or refund of any tax;

(6) Bringing suit upon any such claim for credit or refund;

(7) Assessment of any tax;

(8) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

(9) Collection of the amount of any liability in respect of any tax;

(10) Bringing suit by the United States in respect of any liability in respect of any tax; and

(11) Any other act required or permitted under the internal revenue laws specified by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension. Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

House Bill

No provision.

Senate Amendment

The Senate amendment applies the special suspension of time period rules to persons deployed outside the United States away from the individual's permanent duty station while

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individual. Second, in no event do the suspension of time provisions based on continuous hospitalization inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

participating in an operation designated by the Secretary of Defense as a contingency operation or that becomes a contingency operation. A contingency operation is defined[423] as a military operation that is designated by the Secretary of Defense as an operation in which members of the Armed Forces are or may become involved in military actions, operations, or hostilities against an enemy of the United States or against an opposing military force, or results in the call or order to (or retention of) active duty of members of the uniformed services during a war or a national emergency declared by the President or Congress.

Effective date.–The Senate amendment provision applies to any period for performing an act that has not expired before the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

E. Modification of Membership Requirement for Exemption from Tax for Certain Veterans' Organizations (sec. 905 of the Senate amendment and sec. 501 of the Code)

Present Law

Under present law, a veterans' organization as described in section 501(c)(19) of the Code generally is exempt from taxation. The Code defines such an organization as a post or organization of past or present members of the Armed Forces of the United States: (1) that is organized in the United States or any of its possessions; (2) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and (3) that meets certain membership requirements. The membership requirements are that (1) at least 75 percent of the organization's members are past or present members of the Armed Forces of the United States, and (2) substantially all of the remaining members are cadets or are spouses, widows, or widowers of past or present members of the Armed Forces of the United States or of cadets. No more than 2.5 percent of an organization's total members may consist of individuals who are not veterans, cadets, or spouses, widows, or widowers of such individuals.

Contributions to an organization described in section 501(c)(19) may be deductible for Federal income or gift tax purposes if the organization is a post or organization of war veterans.

House Bill

No provision.

Senate Amendment

The Senate amendment permits ancestors or lineal descendants of past or present members of the Armed Forces of the United States or of cadets to qualify as members for purposes of the "substantially all" test. The Senate amendment does not change the requirement

[423] The definition is by cross-reference to 10 U.S.C. 101.

that 75 percent of the organization's members must be past or present members of the Armed Forces of the United States.

Effective date.–The Senate amendment provision is effective for taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

F. Clarification of Treatment of Certain Dependent Care Assistance Programs Provided to Members of the Uniformed Services of the United States (sec. 906 of the Senate amendment and sec. 134 of the Code)

Present Law

Present law provides that qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) which: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income.

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies that dependent care assistance provided under a dependent care assistance program (as in effect on the date of enactment of this Senate amendment) for a member of the uniformed services by reason of such member's status or service as a member of the uniformed services is excludable from gross income as a qualified military benefit subject to the present-law rules. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. Amounts received under the program also are not considered wages for Federal Insurance Contributions Act tax purposes (including Medicare).

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002. No inference is intended as to the tax treatment of such amounts for prior taxable years.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

G. Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts (sec. 907 of the Senate amendment and secs. 529 and 530 of the Code)

Present Law

The Code provides tax-exempt status to qualified tuition programs, meaning programs established and maintained by a State or agency or instrumentality thereof or by one or more eligible educational institutions under which a person (1) may purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or (2) in the case of a program established by and maintained by a State or agency or instrumentality thereof, may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account. Contributions to qualified tuition programs may be made only in cash. Qualified tuition programs must have adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of amounts necessary to provide for the qualified higher education expenses of the beneficiary.

The Code provides tax-exempt status to Coverdell education savings accounts ("ESAs"), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified education expenses of a designated beneficiary. Contributions to ESAs may be made only in cash. Annual contributions to ESAs may not exceed $2,000 per beneficiary (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18.

Earnings on contributions to an ESA or a qualified tuition program generally are subject to tax when withdrawn. However, distributions from an ESA or qualified tuition program are excludable from the gross income of the distributee to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made.

If the qualified education expenses of the beneficiary for the year are less than the total amount of the distribution from an ESA or qualified tuition program, then the qualified education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. In such a case, only a portion of the earnings is excludable (i.e., the portion of the earnings based on the ratio that the qualified education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary's gross income.

The earnings portion of a distribution from an ESA or a qualified tuition program that is includible in income is generally subject to an additional 10 percent tax. The 10 percent additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary (to the extent it does not exceed the amount of the scholarship).

Service obligations are required of recipients of appointments to the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy. Because of these service obligations, appointments to the Academies are not considered scholarships for purposes of the waiver of the additional 10 percent tax on withdrawals from ESAs and qualified tuition programs that are not used for qualified education purposes.

House Bill

No provision.

Senate Amendment

The Senate amendment permits penalty-free withdrawals from Coverdell education savings accounts and qualified tuition programs made on account of the attendance of the beneficiary at the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy.

The amount of funds that can be withdrawn penalty free is limited to the costs of advanced education as defined in 10 United States Code section 2005(e)(3) (as in effect on the date of the enactment of the Senate amendment) at such Academies.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

H. Suspension of Tax-Exempt Status of Designated Terrorist Organizations (sec. 908 of the Senate amendment and sec. 501 of the Code)

Present Law

Under present law, the Internal Revenue Service generally issues a letter revoking recognition of an organization's tax-exempt status only after (1) conducting an examination of the organization, (2) issuing a letter to the organization proposing revocation, and (3) allowing the organization to exhaust the administrative appeal rights that follow the issuance of the proposed revocation letter. In the case of an organization described in section 501(c)(3), the revocation letter immediately is subject to judicial review under the declaratory judgment procedures of section 7428. To sustain a revocation of tax-exempt status under section 7428, the IRS must demonstrate that the organization is no longer entitled to exemption. There is no procedure under current law for the IRS to suspend the tax-exempt status of an organization.

To combat terrorism, the Federal government has designated a number of organizations as terrorist organizations or supporters of terrorism under the Immigration and Nationality Act, the International Emergency Economic Powers Act, and the United Nations Participation Act of 1945.

House Bill

No provision.

Senate Amendment

The Senate amendment provision suspends the tax-exempt status of an organization that is exempt from tax under section 501(a) for any period during which the organization is designated or identified by U.S. Federal authorities as a terrorist organization or supporter of terrorism. The provision also makes such an organization ineligible to apply for tax exemption under section 501(a). The period of suspension runs from the date the organization is first designated or identified (or from the date of enactment of the provision, whichever is later) to the date when all designations or identifications with respect to the organization have been rescinded pursuant to the law or Executive order under which the designation or identification was made.

The Senate amendment provision describes a terrorist organization as an organization that has been designated or otherwise individually identified (1) as a terrorist organization or foreign terrorist organization under the authority of section 212(a)(3)(B)(vi)(II) or section 219 of the Immigration and Nationality Act; (2) in or pursuant to an Executive order that is related to terrorism and issued under the authority of the International Emergency Economic Powers Act or section 5 of the United Nations Participation Act for the purpose of imposing on such organization an economic or other sanction; or (3) in or pursuant to an Executive order that refers to the provision and is issued under the authority of any Federal law if the organization is designated or otherwise individually identified in or pursuant to such Executive order as supporting or engaging in terrorist activity (as defined in section 212(a)(3)(B) of the Immigration and Nationality Act) or supporting terrorism (as defined in section 140(d)(2) of the Foreign Relations Authorization Act, Fiscal Years 1988 and 1989). During the period of suspension, no deduction for any contribution to a terrorist organization is allowed under the Code, including under sections 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

No organization or other person may challenge, under section 7428 or any other provision of law, in any administrative or judicial proceeding relating to the Federal tax liability of such organization or other person, the suspension of tax-exemption, the ineligibility to apply for tax-exemption, a designation or identification described above, the timing of the period of suspension, or a denial of deduction described above. The suspended organization may maintain other suits or administrative actions against the agency or agencies that designated or identified the organization, for the purpose of challenging such designation or identification (but not the suspension of tax-exempt status under this provision).

If the tax-exemption of an organization is suspended and each designation and identification that has been made with respect to the organization is determined to be erroneous pursuant to the law or Executive order making the designation or identification, and such erroneous designation results in an overpayment of income tax for any taxable year with respect to such organization, a credit or refund (with interest) with respect to such overpayment shall be made. If the operation of any law or rule of law (including res judicata) prevents the credit or refund at any time, the credit or refund may nevertheless be allowed or made if the claim for such credit or refund is filed before the close of the one-year period beginning on the date that the last remaining designation or identification with respect to the organization is determined to be erroneous.

The Senate amendment provision directs the IRS to update the listings of tax-exempt organizations to take account of organizations that have had their exemption suspended and to publish notice to taxpayers of the suspension of an organization's tax-exemption and the fact that contributions to such organization are not deductible during the period of suspension.

Effective date.–The Senate amendment provision is effective for designations made before, on, or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

I. Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members (sec. 909 of the Senate amendment and sec. 162 of the Code)

Present Law

National Guard and Reserve members may claim itemized deductions for their nonreimbursable expenses for transportation, meals, and lodging when they must travel away from home (and stay overnight) to attend National Guard and Reserve meetings. These overnight travel expenses are combined with other miscellaneous itemized deductions on Schedule A of the individual's income tax return and are deductible only to the extent that the aggregate of these deductions exceeds two percent of the taxpayer's adjusted gross income. No deduction is generally permitted for commuting expenses to and from drill meetings.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an above-the-line deduction for the overnight transportation, meals, and lodging expenses of National Guard and Reserve members who must travel away from home more than 100 miles (and stay overnight) to attend National Guard and Reserve meetings. Accordingly, these individuals incurring these expenses can deduct them from gross income regardless of whether they itemize their deductions. The amount of the expenses that may be deducted may not exceed the general Federal Government per diem rate applicable to that locale.

Effective date.–The Senate amendment provision is effective with respect to amounts paid or incurred after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

J. Extension of Certain Tax Relief Provisions to Astronauts (sec. 910 of the Senate amendment and secs. 101, 692, and 2201 of the Code)

Present Law

In general

The Victims of Terrorism Tax Relief Act of 2001 (the "Victims Act") provided certain income and estate tax relief to individuals who die from wounds or injury incurred as a result of the terrorist attacks against the United States on September 11, 2001, and April 19, 1995 (the bombing of the Alfred P. Murrah Federal Building in Oklahoma City) or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002.

Income tax relief

The Victims Act extended relief similar to the present-law treatment of military or civilian employees of the United States who die as a result of terrorist or military activity outside the United States to individuals who die as a result of wounds or injury which were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, and individuals who die as a result of illness incurred due to an attack involving anthrax that occurs on or after September 11, 2001, and before January 1, 2002. Under the Victims Act, such individuals generally are exempt from income tax for the year of death and for prior taxable years beginning with the taxable year prior to the taxable year in which the wounds or injury occurred.[424] The exemption applies to these individuals whether killed in an attack (e.g., in the case of the September 11, 2001, attack in one of the four airplanes or on the ground) or in rescue or recovery operations.

Present law provides a minimum tax relief benefit of $10,000 to each eligible individual regardless of the income tax liability of the individual for the eligible tax years. If an eligible individual's income tax for years eligible for the exclusion under the provision is less than $10,000, the individual is treated as having made a tax payment for such individual's last taxable year in an amount equal to the excess of $10,000 over the amount of tax not imposed under the provision.

Subject to rules prescribed by the Secretary, the exemption from tax does not apply to the tax attributable to (1) deferred compensation which would have been payable after death if the individual had died other than as a specified terrorist victim, or (2) amounts payable in the taxable year which would not have been payable in such taxable year but for an action taken after September 11, 2001. Thus, for example, the exemption does not apply to amounts payable from a qualified plan or individual retirement arrangement to the beneficiary or estate of the

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[424] Present law does not provide relief from self-employment tax liability.

individual. Similarly, amounts payable only as death or survivor's benefits pursuant to deferred compensation preexisting arrangements that would have been paid if the death had occurred for another reason are not covered by the exemption. In addition, if the individual's employer makes adjustments to a plan or arrangement to accelerate the vesting of restricted property or the payment of nonqualified deferred compensation after the date of the particular attack, the exemption does not apply to income received as a result of that action.[425] Also, if the individual's beneficiary cashed in savings bonds of the decedent, the exemption does not apply. On the other hand, the exemption does apply, for example, to a final paycheck of the individual or dividends on stock held by the individual when paid to another person or the individual's estate after the date of death but before the end of the taxable year of the decedent (determined without regard to the death). The exemption also applies to payments of an individual's accrued vacation and accrued sick leave.

The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

<u>Exclusion of death benefits</u>

The Victims Act generally provides an exclusion from gross income for amounts received if such amounts are paid by an employer (whether in a single sum or otherwise[426]) by reason of the death of an employee who dies as a result of wounds or injury which were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occured on or after September 11, 2001, and before January 1, 2002. Subject to rules prescribed by the Secretary, the exclusion does not apply to amounts that would have been payable if the individual had died for a reason other than the attack. The exclusion does apply, however, to death benefits provided under a qualified plan that satisfy the incidental benefit rule.

For purposes of the exclusion, self-employed individuals are treated as employees. Thus, for example, payments by a partnership to the surviving spouse of a partner who died as a result of the September 11, 2001 attacks may be excludable under the provision.

The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

<u>Estate tax relief</u>

Present law provides a reduction in Federal estate tax for taxable estates of U.S. citizens or residents who are active members of the U.S. Armed Forces and who are killed in action

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[425] Such amounts may, however, be excludable from gross income under the death benefit exclusion provided in section 102 of the Victims Act.

[426] Thus, for example, payments made over a period of years could qualify for the exclusion.

while serving in a combat zone (sec. 2201). This provision also applies to active service members who die as a result of wounds, disease, or injury suffered while serving in a combat zone by reason of a hazard to which the service member was subjected as an incident of such service.

In general, the effect of section 2201 is to replace the Federal estate tax that would otherwise be imposed with a Federal estate tax equal to 125 percent of the maximum State death tax credit determined under section 2011(b). Credits against the tax, including the unified credit of section 2010 and the State death tax credit of section 2011, then apply to reduce (or eliminate) the amount of the estate tax payable.

Generally, the reduction in Federal estate taxes under section 2201 is equal in amount to the "additional estate tax." The additional estate tax is the difference between the Federal estate tax imposed by section 2001 and 125 percent of the maximum State death tax credit determined under section 2011(b) as in effect prior to its repeal by the Economic Growth and Tax Relief Reconciliation Act of 2001.

The Victims Act generally treats individuals who die from wounds or injury incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002, in the same manner as if they were active members of the U.S. Armed Forces killed in action while serving in a combat zone or dying as a result of wounds or injury suffered while serving in a combat zone for purposes of section 2201. Consequently, the estates of these individuals are eligible for the reduction in Federal estate tax provided by section 2201. The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

The Victims Act also changes the general operation of section 2201, as it applies to both the estates of service members who qualify for special estate tax treatment under present and prior law and to the estates of individuals who qualify for the special treatment only under the Act. Under the Victims Act, the Federal estate tax is determined in the same manner for all estates that are eligible for Federal estate tax reduction under section 2201. In addition, the executor of an estate that is eligible for special estate tax treatment under section 2201 may elect not to have section 2201 apply to the estate. Thus, in the event that an estate may receive more favorable treatment without the application of section 2201 in the year of death than it would under section 2201, the executor may elect not to apply the provisions of section 2201, and the estate tax owed (if any) would be determined pursuant to the generally applicable rules.

Under the Victims Act, section 2201 no longer reduces Federal estate tax by the amount of the additional estate tax. Instead, the Victims Act provides that the Federal estate tax liability of eligible estates is determined under section 2001 (or section 2101, in the case of decedents who were neither residents nor citizens of the United States), using a rate schedule that is equal to 125 percent of the pre-EGTRRA maximum State death tax credit amount. This rate schedule is used to compute the tax under section 2001(b) or section 2101(b) (i.e., both the tentative tax under section 2001(b)(1) and section 2101(b), and the hypothetical gift tax under section 2001(b)(2) are computed using this rate schedule). As a result of this provision, the estate tax is unified with the gift tax for purposes of section 2201 so that a single graduated (but reduced) rate schedule applies to transfers made by the individual at death, based upon the cumulative taxable transfers made both during lifetime and at death.

In addition, while the Victims Act provides an alternative reduced rate table for purposes of determining the tax under section 2001(b) or section 2101(b), the amount of the unified credit nevertheless is determined as if section 2201 did not apply, based upon the unified credit as in effect on the date of death. For example, in the case of victims of the September 11, 2001, terrorist attack, the applicable unified credit amount under section 2010(c) would be determined by reference to the actual section 2001(c) rate table.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the exclusion from income tax, the exclusion for death benefits, and the estate tax relief available under the Victims of Terrorism Tax Relief Act of 2001 to astronauts who lose their lives on a space mission (including the individuals who lost their lives in the space shuttle Columbia disaster).

Effective date.–The Senate amendment provision is generally effective for qualified individuals whose lives are lost on a space mission after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

XII. SUNSET PROVISION

A. Termination of Certain Provisions (sec. 1001 of the Senate amendment)

Present Law

Budget reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions: (1) it does not produce a change in outlays or revenues; (2) it produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions; (3) it is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure; (4) it produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision; (5) it would increase the deficit for a fiscal year beyond those covered by the reconciliation measure; or (6) it recommends changes in Social Security.

House Bill

No provision.

Senate Amendment

To ensure compliance with the Budget Act, the Senate amendment provides that certain provisions of, and amendments made by, the bill do not apply for taxable years beginning after December 31, 2012.

Effective date.–The Senate amendment provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment.

The conference agreement does not modify the application of the Economic Growth Tax Reconciliation Relief Act of 2001 ("EGTRRA") sunset provision. The EGTRRA provision is contained in Title IX of Pub. L. No.107-16.

XIII. TAX COMPLEXITY ANALYSIS

The following tax complexity analysis is provided pursuant to section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998, which requires the staff of the Joint Committee on Taxation (in consultation with the Internal Revenue Service ("IRS") and the Treasury Department) to provide a complexity analysis of tax legislation reported by the House Committee on Ways and Means, the Senate Committee on Finance, or a Conference Report containing tax provisions. The complexity analysis is required to report on the complexity and administrative issues raised by provisions that directly or indirectly amend the Internal Revenue Code and that have widespread applicability to individuals or small businesses. For each such provision identified by the staff of the Joint Committee on Taxation, a summary description of the provision is provided along with an estimate of the number and type of affected taxpayers, and a discussion regarding the relevant complexity and administrative issues.

Following the analysis of the staff of the Joint Committee on Taxation are the comments of the IRS and the Treasury Department regarding each of the provisions included in the complexity analysis, including a discussion of the likely effect on IRS forms and any expected impact on the IRS.

1. Increase the child tax credit (sec. 101 of the conference agreement)

Summary description of provision

The amount of the child credit is increased to $1,000 for 2003 and 2004, reverting to present law phase-in thereafter. For 2003, the increased amount of the child credit will be paid in advance beginning in July 2003 on the basis of information on each taxpayer's 2002 return filed in 2003. Advance payments will be made in a manner similar to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket.

Number of affected taxpayers

It is estimated that the provisions will affect approximately 27 million individual tax returns.

Discussion

Individuals should not have to keep additional records due to this provision, nor will additional regulatory guidance be necessary to implement this provision.

The IRS will need to add to the individual income tax forms package a new worksheet so that taxpayers can reconcile the amount of the check they receive from the Department of the Treasury with the credit they are allowed as an acceleration of the child tax credit for 2003. This worksheet should be relatively simple and many taxpayers will not need to fill it out completely because they will have received the full amount by check.

2. Expansion of the 15-percent rate bracket (sec. 102 of the conference agreement)

Summary description of provision

The bill accelerates the increase of the size of the 15-percent regular income tax rate bracket for married individuals filing joint returns to twice the width of the 15-percent regular income tax rate bracket for unmarried individual returns effective for 2003 and 2004, reverting to present-law phase-in for 2005 and thereafter.

Number of affected taxpayers

It is estimated that the provision will affect approximately 19 million individual tax returns.

Discussion

It is not anticipated that individuals will need to keep additional records due to this provision. The increased size of the 15-percent regular income tax rate bracket for married individuals filing joint returns should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this provision.

3. Standard deduction tax relief (sec. 103 of the conference agreement)

Summary description of provision

The conference agreement accelerates the increase in the basic standard deduction amount for joint returns to twice the basic standard deduction amount for unmarried individual returns effective for 2003 and 2004, reverting to present-law phase-in for 2005 and thereafter.

Number of affected taxpayers

It is estimated that the provision will affect approximately 22 million individual returns.

Discussion

It is not anticipated that individuals will need to keep additional records due to this provision. The higher basic standard deduction should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this provision. In addition, the provision should not increase individuals' tax preparation costs.

Some taxpayers who currently itemize deductions may respond to the provision by claiming the increased standard deduction in lieu of itemizing. According to estimates by the staff of the Joint Committee on Taxation, approximately three million individual tax returns will realize greater tax savings from the increased standard deduction than from itemizing their deductions. In addition to the tax savings, such taxpayers will no longer have to file Schedule A to Form 1040 and a significant number of which will no longer need to engage in the record keeping inherent in itemizing below-the-line deductions. Moreover, by claiming the standard deduction, such taxpayers may qualify to use simpler versions of the Form 1040 (i.e., Form

1040EZ or Form 1040A) that are not available to individuals who itemize their deductions. These forms simplify the return preparation process by eliminating from the Form 1040 those items that do not apply to particular taxpayers.

This reduction in complexity and record keeping also may result in a decline in the number of individuals using a tax preparation service or a decline in the cost of using such a service. Furthermore, if the provision results in a taxpayer qualifying to use one of the simpler versions of the Form 1040, the taxpayer may be eligible to file a paperless Federal tax return by telephone. The provision also should reduce the number of disputes between taxpayers and the IRS regarding substantiation of itemized deductions.

4. Reduction in income tax rates for individuals (secs. 104 and 105 of the conference agreement)

Summary description of provision

The conference agreement accelerates the scheduled increase in the taxable income levels for the 10-percent rate bracket from 2008 to 2003 and 2004, reverting to the present-law phasein for 2005 and thereafter. Specifically, the conference agreement increases the taxable income level for the 10-percent regular income tax rate brackets for unmarried individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. For taxable years beginning after 2004, the amounts will revert to the levels provided in present-law (e.g., $7,000 for unmarried individuals and $12,000 for married couples filing jointly for 2005).

Also, the conference agreement accelerates the reductions in the regular income tax rates in excess of the 15-percent regular income tax rate that are scheduled for 2004 and 2006. Therefore, the regular income tax rates in excess of 15 percent under the conference agreement are 25 percent, 28 percent, 33 percent, and 35 percent for 2003 and thereafter.

Number of affected taxpayers

It is estimated that the provision will affect approximately 76 million individual tax returns.

Discussion

It is not anticipated that individuals will need to keep additional records due to this provision. It should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this provision. In addition, the provision should not increase the tax preparation costs for most individuals. Reductions in the regular income tax as a result of these rate reductions as well as the expansion of the child credit, standard deduction, and 10-percent bracket, will cause some taxpayers to become subject to the alternative minimum tax.

The Secretary of the Treasury is expected to make appropriate revisions to the wage withholding tables to reflect the proposed rate reduction for calendar year 2003 as expeditiously as possible. To implement the effects of the additional amount of child tax credit for 2003, employers would be required to use a new (second) set of withholding rate tables to determine the correct withholding amounts for each employee. Switching to the new withholding rate tables during the year can be expected to result in a one-time additional burden for employers.

5. Bonus depreciation (sec. 201 of the conference agreement)

Summary description of provision

The conference agreement provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the Job Creation and Workers Assistance Act of 2002, except that the applicable time period for acquisition (or self construction) of the property is modified. In general, in order to qualify the property must be acquired after May 5, 2003, and before January 1, 2005, and no binding written contract for the acquisition is in effect before May 6, 2003. Property eligible for the 50-percent additional first year depreciation deduction is not eligible for the 30-percent additional first year depreciation deduction.

Number of affected taxpayers

It is estimated that more than 10 percent of small businesses will be affected by the provision.

Discussion

It is not anticipated that small businesses will have to keep additional records due to this provision, nor will additional regulatory guidance be necessary to implement this provision. It is not anticipated that the provision will result in an increase in disputes between small businesses and the IRS. However, small businesses will have to perform additional analysis to determine whether property qualifies for the provision. In addition, for qualified property, small businesses will be required to perform additional calculations to determine the proper amount of allowable depreciation. Complexity may also be increased because the provision is temporary. For example, different tax treatment will apply for identical equipment based on the acquisition and placed in service date. Further, the Secretary of the Treasury is expected to have to make appropriate revisions to the applicable depreciation tax forms.

6. Capital gain rate reduction (sec. 301 of the conference agreement)

Summary description of provision

The conference agreement reduces the 10- and 20-percent rates on the adjusted net capital gain to five and 15 percent, respectively. These lower rates apply to both the regular tax and the alternative minimum tax. The lower rates apply to assets held more than one year. The five percent rate becomes zero percent for taxable years beginning after 2007. The conference agreement applies to taxable years ending on or after May 6, 2003, and beginning before January 1, 2009.

For taxable years that include May 6, 2003, the lower rates apply to amounts properly taken into account for the portion of the year on or after that date. This generally has the effect of applying the lower rates to capital assets sold or exchanged (and installment payments received) on or after May 6, 2003. In the case of gain and loss taken into account by a pass-through entity, the date taken into account by the entity is the appropriate date for applying this rule.

Number of affected taxpayers

It is estimated that the provisions will affect over 15 million individual tax returns.

Discussion

The elimination of the five-year holding period means that taxpayers with gains on assets held for more than 5 years will no longer need to separately compute tax for such gain on schedule D of Form 1040. Additionally, the form will not need to be expanded beginning in 2006 to separate out gain of capital assets held more than five years that were purchased after 2000. This may reduce tax preparation costs. Mutual fund reporting on the Form 1099 will be made easier by the elimination of the five-year holding period.

For 2003, multiple rates will be in effect depending on whether gain was realized before or after May 6, 2003. This will make the schedule D more complicated for tax year 2003, and may increase tax preparation costs.

7. Dividend tax relief (sec. 302 of the conference agreement)

Summary description of provision

Under the conference agreement, qualified dividends received by an individual shareholder from domestic and qualified foreign corporations are generally taxed at the rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, under the conference agreement, dividends will be taxed at rates of five and 15 percent, the same rates applicable to net capital gain.

If a shareholder does not hold a share of stock for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date, dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Number of affected taxpayers

It is estimated that the provisions will affect over 20 million individual tax returns.

Discussion

Individuals computing their tax will need to add qualified dividends to net capital gain in computing their income tax using the tax computation portion of Schedule D of Form 1040 (or other tax computation forms or schedules as the Internal Revenue Service may prescribe).

Additional individuals will need to use the tax computation schedule, which may increase tax preparation costs.

New Form 1099s will need to differentiate qualified from nonqualified dividends, and additional burdens will be imposed on payors to comply with the new Form 1099 reporting. Additional record keeping will be necessary with respect to compliance with the 60-day holding period rules. It is likely that there will be increased taxpayer errors with respect to the proper reporting of dividends as a result.

8. ~~**[insert IRS letter]**~~

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

Ms. Mary Schmitt
Acting Chief of Staff
Joint Committee on Taxation
Washington, D.C. 20515

Dear Ms. Schmitt:

Enclosed are the combined comments of the Internal Revenue Service and the Treasury Department on the seven provisions from the House and Senate markup of H.R. 2, the "Jobs and Growth Tax Relief Reconciliation Act of 2003," that your staff identified for complexity analysis in their May 22, 2003 telephone calls to the IRS Legislative Affairs Division.

Our comments are based on the description of those provisions in the enclosed analysis. Due to the short turnaround time, our comments are provisional and subject to change upon a more complete and in-depth analysis of the provisions.

Sincerely,

Keri M. Brown/For Mark Everson

Mark W. Everson

Enclosure

COMPLEXITY ANALYSIS OF THE
JOBS AND GROWTH RECONCILIATION TAX ACT OF 2003

Acceleration of the Increase In the Child Tax Credit

Provision:

The amount of the child credit is increased to $1,000 for 2003 and 2004. For 2003, the increased amount ($400) will be paid in advance beginning in July 2003 on the basis of information on each taxpayer's 2002 return. Advance payments are to be made in a similar manner to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket. After 2005 the child credit will revert to the levels provided in present law (e.g., $700 for 2005).

IRS and Treasury Comments:

- No new forms would be required as a result of the child tax credit provisions mentioned above.
- The increased amount of the child tax credit and the increased refundable portion would be incorporated in the instructions for Forms 1040, 1040A, 1040NR, 1040-PR, and 1040-SS for 2003 and 2004.
- The applicable amount of the child tax credit for 2005 and later years would be incorporated in the instructions for Form 1040, 1040A, 1040NR, 1040-PR, and on Form 1040-ES for 2005 and later years.
- Subsequent to enactment, the IRS would have to advise taxpayers who make estimated tax payments for 2003 how they can adjust their estimated tax payments for 2003 to reflect the increased child tax credit, the increased refundable portion, and the required reduction for those who receive advance payments.
- Supplemental programming changes would be required for processing 2003 returns to reflect the increased child tax credit, the increased refundable portion, and the required reduction for those who receive advance payments.
- Programming changes would be required for 2004 and later years to reflect the reversion of the applicable child tax credit amount to the amounts currently scheduled for the years. Currently, the IRS computation programs are updated annually to incorporate mandated inflation adjustments. Programming changes necessitated by the provision would be included during that process.

Advance Payment Feature

- An estimated 26 million checks will be mailed beginning in July 2003.
- It will take three weeks to mail checks to those taxpayers whose 2002 tax returns have already been filed and processed. Checks for taxpayers whose returns are filed and processed later in the year will be mailed weekly, through the end of December 2003.
- Some taxpayers may be entitled to more than their advance payment checks due to changes in financial or family status between 2002 and 2003. For example, IRS will not know if a taxpayer gives birth to a child or adopts a child in 2003 until the taxpayer files the 2003 tax return. If they are entitled to a larger increase in the child tax credit than they received in their advance payment checks, they will get the additional amounts on their 2003 tax returns.
- Notices will be sent to taxpayers informing them of the amount of their advance payment, the number of children used to compute the amount, if the amount was limited due to the phase-out range, tax liability, or earned income. The notices will also advise taxpayers that this amount will have to be taken into account in determining the amount of their child tax credit on the 2003 tax return.
- Two lines will be added to the Child Tax Credit Worksheet for 2003. Based on experience with the 2001 rate reduction credit and advance payment, it is anticipated that a number of taxpayers will make errors in this computation on their 2003 tax returns.
- The advance payment will require programming changes to compute the amount and resources to answer taxpayer questions, print and mail notices, and correct errors made on 2003 returns as a result of the advance payment

Acceleration of the Standard Deduction Tax Relief

Provision:

The basic standard deduction amount for joint returns is increased to twice the basic standard deduction amount for unmarried individual returns, effective for 2003 and 2004. After 2004, the applicable percentages will revert to present-law levels (e.g., 174 percent of the basic standard deduction for unmarried individuals for 2005).

IRS and Treasury Comments:

- The increased basic standard deduction for married taxpayers would be incorporated in the instructions for Forms 1040, 1040A, 1040EZ, and on Forms 1040, 1040A, and 1040EZ for 2003, 2004, and 2005. No new forms would be required.

- The amount of the basic standard deduction for married taxpayers after 2004 (based on reversion to the currently scheduled levels) would be incorporated in the instructions for Forms 1040, 1040A, 1040EZ, and on Forms W-4, 1040, 1040A, 1040EZ, and 1040-ES for 2005 and later years.

- Subsequent to enactment, the IRS would have to advise taxpayers how they can adjust their estimated tax payment or federal income tax withholding for 2003 to reflect the increased basic standard deduction.

- Supplemental programming changes would be required to reflect the increased basic standard deduction for 2003.

- Programming changes would be required in 2005 and later to reflect the reversion of the standard deduction amounts to the currently scheduled amounts for those years. Currently, the IRS computation programs are updated annually to incorporate mandated inflation adjustment. Programming changes necessitated by the provision would be included during that process.

- The larger basic standard deduction would reduce the number of taxpayers who itemize their deductions in 2003 and 2004. It would also reduce the number of taxpayers who are required to file income tax returns in those years.

Acceleration of the Expansion of the 15-Percent Rate Bracket

Provision:

The width of the 15-percent regular income tax rate bracket for joint returns is increased to twice the width of the 15-percent regular income tax rate bracket for unmarried individual returns, effective for 2003 and 2004. After 2004, the end point of the 15-percent rate bracket for married couples filing joint returns (as a percentage of the end point of the 15-percent rate bracket for unmarried individuals) will revert to present-law levels (i.e., 180 percent of the end point of the 15-percent rate bracket for unmarried individuals for 2005).

IRS and Treasury Comments:

- The expanded 15-percent rate bracket for married taxpayers would be incorporated in the tax tables and the tax rate schedules shown in the instructions for Forms 1040, 1040A, 1040EZ, and 1040NR for 2003 and 2004. No new forms would be required.

- The applicable width of the 15-percent rate bracket for married taxpayers after 2004 (based on reversion to the currently scheduled levels) would be incorporated in the tax tables and tax rate schedules shown in the instructions for

Forms 1040, 1040A, 1040EZ, and 1040NR and on Form 1040-ES for 2005 and later years.

- The expanded 15-percent rate bracket would also be incorporated in the tax rate schedules shown on Form 1040-ES for 2004. Subsequent to enactment, the IRS would have to advise taxpayers who make estimated tax payments for 2003 how they can adjust their estimated tax payments for 2003 to reflect the expanded 15-percent rate bracket.

- Supplemental programming changes would be required to reflect the expanded 15-percent rate bracket for 2003.

- Programming changes would be required to reflect the reversion to present law levels for determining the width of the 15-percent rate bracket for 2005 and later years. Currently, the IRS computation programs are updated annually to incorporate mandated inflation adjustments. Programming changes necessitated by the provision would be included during that process.

- New withholding rate tables and schedules to update the current Circular E for use by employers during the remainder of calendar year 2003 would be required.

Acceleration of the Reduction of Regular Individual Income Tax Rates

Provision:

The conference agreement accelerates the scheduled increase in the taxable income levels for the 10-percent rate bracket from 2008 to 2003 and 2004, reverting to the present-law phase-in for 2005 and thereafter. Specifically, the conference agreement increases the taxable income level for the 10-percent regular income tax rate brackets for unmarried individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. For taxable years beginning after 2004, the amounts will revert to the levels provided in present-law (i.e., $6,000 for unmarried individuals and $12,000 for married couples filing jointly for 2005).

Also, the conference agreement accelerates the reductions in the regular income tax rates in excess of the 15-percent regular income tax rate that are scheduled for 2004 and 2006. Therefore, the regular income tax rates in excess of 15 percent under the conference agreement are 25 percent, 28 percent, 33 percent, and 35 percent for 2003 and thereafter.

IRS and Treasury Comments:

- No new forms would be required as a result of the above-mentioned provisions.

- The increased taxable income levels for the 10-percent rate bracket would be incorporated in the tax tables and tax rate schedules shown in the instructions for Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR-EZ for 2003 and 2004.

- The reduced tax rates would be incorporated in the tax tables and tax rate schedules shown in the instructions for Forms 1040, 1040A, 1040EZ, 1040NR, 1040NR-EZ, and 1041 for 2003 and 2004.

- Changes to the 10-percent rate bracket for tax years beginning after 2004 resulting from the reversion to the present-law phase-in schedule would be incorporated in the tax tables and tax rate schedules shown in the instructions for Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR-EZ and on Form 1040-ES for 2005 and later years. Currently, the IRS computation programs are updated annually to incorporate mandated inflation adjustments. Programming changes necessitated by the provision would be included during that process.

- The increased taxable income levels for the 10-percent rate bracket and the reduced tax rates would also be incorporated in the tax rate schedules shown on Form 1040-ES for 2004. Subsequent to enactment, the IRS would have to advise taxpayers who make estimated tax payments for 2003 how they can adjust their estimated tax payments for 2003 to reflect the increased taxable income levels for the 10-percent rate bracket and the reduced rates.

Special Depreciation Allowance for Certain Property

Provision:

The bill provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the Job Creation and Workers Assistance Act of 2002, except that the applicable time period for acquisition (or self construction) of the property is modified. In general, in order to qualify, the property must be acquired after May 5, 2003, and before January 1, 2006, and no binding written contract for the acquisition can be in effect before May 6, 2003. Property eligible for the 50-percent additional first-year depreciation deduction is not eligible for the 30-percent additional first-year depreciation deduction.

IRS and Treasury Comments:

- The increase and extension of additional first-year depreciation would have no significant impact on Form 4562 or any other tax forms. The instructions for Form 4562 and other instructions and publications would be expanded to explain and implement the new rules.
- No programming changes would be required by this provision.

Reduced Individual Capital Gains Rates

Provision:

The 10- and 20-percent rates on the adjusted net capital gain are reduced to 5 and 15 percent, respectively, effective in taxable years ending on or after May 6, 2003, and beginning before January 1, 2009.

For taxable years that include May 6, 2003, the lower rates apply to amounts properly taken into account for the portion of the year on or after that date. This generally has the effect of applying the lower rates to capital assets sold or exchanged (and installment payments received) on or after May 6, 2003.

IRS and Treasury Comments:

- The mid-year effective date of May 6, 2003, creates complexity and burden for taxpayers, and will likely result in a large number of errors (as occurred in 1997 when similar mid-year changes were made to the capital gains tax rate). A January 1, 2003, effective date would greatly simplify matters for 2003 (instead of adding 8 lines to several products for 2003 as described below, 4 lines would be removed).

- To figure the amount of gain taxed at 5% and 15% for 2003, 8 lines would be added to: Schedule D (Form 1040); the Schedule D Tax Worksheet; Form 6251 (alternative minimum tax); and Form 8801 (credit for prior year minimum tax).

- Column (g) of Schedule D would be revised to request information for amounts applicable to the portion of the tax year after May 5, 2003. Additional instructions and a 6-line worksheet would be added to figure 28% rate gain or loss, as that amount is currently figured in column (g).

- Rules would have to be developed and applied for 2003 to account for the limit on net section 1231 losses, capital loss carryforwards, carryforwards not allowed due to passive activity rules or at-risk rules, etc.

- The amount of net capital gain for the portion of the tax year after May 5, 2003, would have to be transcribed from the tax return and programming changes would be required to figure the amount of gain taxed at 5% and 15%.

- For 2003, Form 1099-DIV filers would be required to figure and report to recipients the amount of gain after May 5, 2003.

- Taxpayers whose only capital gains are capital gain distributions would not be able to use the shorter Capital Gain Tax Worksheet in the instructions for Form 1040 and Form 1040A, but instead would be required to file Form 1040 and attach Schedule D, to report the amount of their capital gain distributions properly taken into account after May 5, 2003, and figure their tax using the 5%, 10%, 15%, and

20% capital gains tax rates. This provision would therefore increase the number of taxpayers filing Schedule D by up to 6 million.

- For 2004, the 8 lines added for 2003 and 4 current lines (used to figure the 8% rate) would be removed from: Schedule D; the Schedule D Tax Worksheet; Form 6251; and Form 8801.
- The 8-line Qualified 5-Year Gain Worksheet in the Instructions for Schedule D would not be necessary after 2003.
- For 2006, when the 18% capital gains tax rate becomes effective for individuals, this provision would also save us from having to add 4 lines to Schedule D, the Schedule D Tax Worksheet, Form 6251, Form 8801, and the Qualified 5-Year Gain Worksheet.
- Form 1099-DIV filers would not be required to report qualified 5-year gain after 2003, and would not be required in 2005 to begin reporting qualified 5-year gain eligible for the 18% rate.
- For tax years beginning after 2008, the 5% and 15% rates would cease to apply, the 8% rate on qualified 5-year gain would again apply, and the 18% rate on qualified 5-year gain on property acquired after 2000 would begin to apply. At least 8 lines would have to be added to the 2009 Schedule D (Form 1040) and 2009 Schedule D Tax Worksheet, 2009 Form 6251, and Form 8801. A worksheet of at least 8 lines would be required to figure the 8% and 18% qualified 5-year gain amounts. Several million taxpayers, filing Form 1040 or 1040A, whose only capital gains are capital gain distributions and dividends would no longer be eligible to figure their tax using a short Capital Gain Tax Worksheet, but instead would be required to file Form 1040 and Schedule D. Form 1099-DIV filers would again have to track and report 8% qualified 5-year gain, and would have to begin reporting 18% qualified 5 year gain.

Dividend Income of Individuals

Provision:

Dividends received by an individual shareholder from domestic corporations are taxed at the rates for net capital gain (5 or 15 percent per the above reduction in the capital gains rate), effective for taxable years beginning after 2002 and before 2013.

If a shareholder does not hold a share of stock for more than 60 days during the 90-day period beginning 60 days before the ex-dividend date, dividends received on the stock are not eligible for the capital gain rates. Also, the capital gain rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property. Other rules apply.

IRS and Treasury Comments:

- No new forms would be required as a result of the above-mentioned provision.
- A box to report qualified dividends would be added to Form 1099-DIV for 2004 through 2012.
- Subsequent to enactment, the IRS would have to issue a revised Form 1099-DIV for 2003 and advise taxpayers who make estimated tax payments for 2003 how they can adjust their estimated tax payments to reflect the new tax rates applicable to qualified dividends.
- Two lines would be added to Part IV of Schedule D (and the Schedule D Tax Worksheet) for 2003 through 2012 to increase net capital gain by the amount of qualified dividends.
- The new tax rates applicable to qualified dividends would be reflected in the instructions for Forms 1040 and 1040A for 2003 through 2012.
- Taxpayers who have qualified dividends would be required to report them on Schedule D and complete up to 19 lines (23 lines for 2003) in Part IV of Schedule D to figure their tax using the 15% and 5% capital gains tax rates, even if they did not otherwise have a net capital gain. For example, taxpayers whose only income was wages, interest, and dividends reported on Form 1040A would now be required to file Form 1040 and attach Schedule D to report the amount of qualified dividends and figure their tax.
- Supplemental programming changes would be required to reflect the new tax rates applicable to qualified dividends for 2003.
- Programming changes would be required to reflect the tax rates applicable to qualified dividends after 2012. Currently, the IRS tax computation programs are updated annually to incorporate mandated inflation adjustments. Programming changes necessitated by the provision would be included during that process.
- Technical guidance (regulations, revenue rulings, etc.) will probably be needed to implement the anti-abuse rules.
- For tax years beginning after 2008, the additional lines added for 2003-2007--one line for Form 1040 and two lines in each place tax is figured using capital gains tax rates (Schedule D, Schedule D Tax Worksheet, and Capital Gain Tax Worksheets)--would be removed.

Effect of All Bill Provisions on AMT

Despite specific changes which tend to increase the number of AMT taxpayers, the bill's increases in the AMT exemption amounts for 2003-2004 would significantly reduce the number of AMT taxpayers in those years relative to current law.

ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 2
THE "JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003"

Fiscal Years 2003 - 2013

[Millions of Dollars]

Provision	Effective	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2003-08	2003-13
Acceleration of Certain Previously Enacted Tax Reductions														
1. Expand the child credit to $1,000 for 2003 through 2004; revert to present-law phase in for 2005 [1]	tyba 12/31/02	-13,712	-5,820	-12,956	---	---	---	---	---	---	---	---	-32,488	-32,488
2. Accelerate the expansion of the 15% individual income tax rate bracket and the increase in the standard deduction for married taxpayers filing joint returns; revert to present-law phase in for 2005	tyba 12/31/02	-4,936	-24,904	-5,234	---	---	---	---	---	---	---	---	-35,074	-35,074
3. Accelerate the expansion of the 10% bracket; revert to present-law phase in for 2005	tyba 12/31/02	-1,549	-8,445	-1,912	---	---	---	---	---	---	---	---	-11,906	-11,906
4. Accelerate the 2006 rate schedule	tyba 12/31/02	-9,531	-38,809	-19,930	-5,915	---	---	---	---	---	---	---	-74,185	-74,185
5. Increase individual AMT exemption amount by $4,500 single and $9,000 joint for 2003 and 2004	tyba 12/31/02	-1,176	-10,346	-6,260	---	---	---	---	---	---	---	---	-17,782	-17,782
Total of Acceleration of Certain Previously Enacted Tax Reductions		**-30,904**	**-88,324**	**-46,292**	**-5,915**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**-171,435**	**-171,435**
Growth Incentives for Business														
1. Increase bonus depreciation to 50% and extend through 12/31/04	ppisa 5/5/03 [2]	-9,918	-33,298	-11,684	9,414	9,300	8,112	6,648	4,987	3,586	2,212	1,447	-28,074	-9,194
2. Increase section 179 expensing - increase the amount that can be expensed from $25,000 to $100,000 and increase the phaseout threshold amount from $200,000 to $400,000; include software in section 179 property; and index both the deduction limit and the phaseout threshold after 2003 (sunset after 2005)	tyba 12/31/02	-1,647	-2,681	-3,690	-1,027	2,724	1,842	1,290	937	647	410	243	-4,479	-952
Total of Growth Incentives for Business		**-11,565**	**-35,979**	**-15,374**	**8,387**	**12,024**	**9,954**	**7,938**	**5,924**	**4,233**	**2,622**	**1,690**	**-32,553**	**-10,146**
Reductions in Taxes on Dividends and Capital Gains														
1. Tax capital gains with a 15%/5% rate structure for 2003 though 2007, and 15%/0% in 2008 (sunset 12/31/08)	so/a 5/6/03	-62	-928	-1,335	-3,042	-4,454	-3,544	509	-9,532	---	---	---	-13,365	-22,386
2. Tax dividends with a 15%/5% rate structure for 2003 though 2007, and 15%/0% in 2008 (sunset 12/31/08) [3]	dri tyba 12/31/02	-4,250	-17,506	-19,215	-20,081	-21,263	-23,203	-19,689	-493	---	---	---	-105,518	-125,700
Total of Reductions in Taxes on Dividends and Capital Gains		**-4,312**	**-18,434**	**-20,550**	**-23,123**	**-25,717**	**-26,747**	**-19,180**	**-10,025**	**---**	**---**	**---**	**-118,883**	**-148,086**

Provision	Effective	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2003-08	2003-13
Temporary State Fiscal Relief Fund (outlay effects) [4]	DOE	-7,730	-12,270	---	---	---	---	---	---	---	---	---	-20,000	-20,000
Special Estimated Tax Rules for Certain Corporate Estimated Tax Payments (25% of estimated payments otherwise due on September 15 are payable on October 1, 2003)	DOE	-6,325	6,325	---	---	---	---	---	---	---	---	---	---	---
Total, Net of Outlays		-49,489	-135,370	-77,567	-20,575	-13,648	-16,749	-11,190	-4,101	4,233	2,622	1,690	-313,398	-320,142
Total Outlay Effects		-11,347	-13,312	-4,649	-76	-45	-44	-52	---	---	---	---	-29,473	-29,525
TOTAL [5]		-60,836	-148,682	-82,216	-20,651	-13,693	-16,793	-11,242	-4,101	4,233	2,622	1,690	-342,871	-349,667

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:
DOE = date of enactment
dri = dividends received in
ppisa = property placed in service after
so/a = sales on or after
tyba = taxable years beginning after

[1] Advance payment of 2003 child credit paid by rebate with safe harbor.
[2] Does not apply to any property with binding contract in place before May 6, 2003.
[3] Any dividend described in Internal Revenue Code section 404(k) would be taxed at ordinary rates. RIC and REIT shareholders receive tax relief to the extent that dividends paid by the RIC or REIT are qualified dividends received by the RIC or REIT. Taxed REIT income would receive the preferential tax rates when distributed as dividends. The provision excludes qualified dividends from investment income for the purpose of Internal Revenue Code Section 163(d). Certain anti-abuse rules, including the imposition of a 60-day holding period, apply. Certain foreign dividends would qualify for the preferential rates.
[4] Estimate provided by the Congressional Budget Office.
[5] Returns with AMT liability (millions):

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Present law	2.2	3.7	9.7	14.9	19.2	23.8	26.8	30.0	14.2	17.3	20.3
Change due to proposal	0.2	-0.8	1.6	---	---	---	---	---	---	---	---

H.R. 2

Managers on the part of the HOUSE	*Managers on the part of the* SENATE
William M. Thomas Mr. Thomas	
Tom DeLay Mr. DeLay	
[redacted]	

H.R. 2—Continued

Managers on the part of the HOUSE	*Managers on the part of the* SENATE
	Mr. Grassley Chuck Grassley
	Mr. Hatch Orrin Hatch
	Mr. Nickles D Nickles
	Mr. Lott Trent Lott
	[redacted]
	[redacted]
	[redacted]